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Too Small to Collect Big Data: Financial Inclusion Implications

Congress has demonstrated an ongoing interest in promoting financial inclusion (i.e., increasing the access of traditionally underserved populations and markets to affordable financial services and products). The concept of financial inclusion has evolved to include the adoption of digital technologies, which can enhance the effectiveness of *regtech*—the use of technology by both regulators and regulated entities to facilitate compliance with applicable regulations and policy objectives. While regtech can be used to monitor prudential financial (e.g., credit, liquidity, interest rate) risks, it can also be deployed to analyze the circulation of financial products and services, thus monitoring the breadth of inclusiveness. Regtech relies upon collecting and organizing digital data, which may be costly for certain institutions—especially those that serve predominantly customers facing appreciable financial challenges.

Regtech and Financial Risk Reporting

U.S. depository institutions (i.e., banks and credit unions) have mandatory quarterly data reporting requirements, which allow regulators to monitor institutions' financial health. Every quarter, banks and credit unions submit data (referred to as *call report* data) to their primary regulators for aggregation and analysis. In September 2014, the Office of the Comptroller of the Currency (OCC) finalized guidance to heighten standards for the largest U.S. banks, including the data aggregation and reporting capabilities that would be appropriate for their size, complexity, and risk profiles as well as to support supervisory reporting requirements. Implementation of the necessary information technology (IT) infrastructures reportedly still remains challenging and costly for many large banks.

Some Data Reporting Exemptions

For laws designed to monitor financial inclusion, exemptions for data collection exist for certain entities and circumstances, namely depositories that are small or have a small footprint in a particular lending market, discussed in the examples below.

Home Mortgage Disclosure Act (HMDA)

The Home Mortgage Disclosure Act of 1975 (HMDA; P.L. 94-200) required originators to disclose mortgage information to facilitate the monitoring of lending activity. The 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act, P.L. 111-203) required the collection of credit scores under HMDA. Using its discretionary authority to carry out the purposes of HMDA, the Consumer Financial Protection Bureau (CFPB) also required some additional data collection. However, the 2018 Economic Growth, Regulatory Relief, and Consumer Protection Act (P.L. 115-174) required the CFPB to implement certain statutory reporting thresholds. Federally insured banks and credit unions that originate fewer than 100 closed-end mortgage loans in either of the two preceding calendar years no longer need to report such data effective July 1, 2020. (The previous threshold was set at 25 closed-end loans.) The permanent threshold for reporting data about open-end lines of credit was also set at 200 open-end lines of credit effective January 1, 2022 (following expiration of the temporary higher threshold of 500 open-end lines of credit that was increased from 100 in 2018). Going forward, HMDA data are likely to contain less information about mortgage lending, pricing practices, and characteristics of borrowers in rural areas.

Section 1071: Database for Women- and Minority-Owned Small Business Credit

On July 24, 2020, the CFPB released an Advance Notice of Proposed Rulemaking (ANPR) for Section 1071 of the Dodd-Frank Act. Section 1071 requires financial institutions to collect data pertaining to credit applications for women-owned, minority-owned, and small businesses. The data would then be reported annually to the CFPB, thus having some similar attributes to the HMDA database. The ANPR states that reporting requirements would not apply to small businesses that are not owned by women or minorities, and they would not apply to women- and minority-owned businesses that do not meet the Small Business Administration's definitions of *small*. Consequently, a full understanding of how the experiences of women and minority firms that apply for small business loans differ from other small firms looks to be more difficult without the ability to make extensive comparisons. The CFPB is also considering collection and reporting exemptions based on either a size-based or activity-based threshold or both. Many small lenders have historically been a primary funding source for small businesses and especially early-stage start-ups. Requiring data reporting from small lenders has challenges, which are discussed in the last section.

Community Reinvestment Act (CRA)

The Community Reinvestment Act (CRA; P.L. 95-128) was enacted to encourage federally insured banks to meet the credit needs of the communities in which they accept deposits. Since passage, restrictions on interstate banking and branching were lifted, and online and mobile banking has increased. Thus, the federal bank regulators have focused on updating the current CRA regulatory framework to incorporate banking activities that occur outside of geographical boundaries.

While federal bank regulators typically engage in joint CRA rulemaking, the OCC on May 20, 2020, finalized its updated CRA framework, which aims to provide for more timely and transparent CRA-related data collection, recordkeeping, and reporting. The OCC reported receiving numerous comments on proposed data collection, recordkeeping, and reporting requirements. In response, the final rule accounts for the differences among the categories of institutions to reduce the burden with regard to data collection and data integrity requirements. For example, banks with less than $2.5 billion in assets are generally exempted from being evaluated under the newly adopted CRA performance standards but may opt in. On September 21, 2020, the Federal Reserve released an ANPR to obtain feedback on its tentative plans to update the CRA framework for the entities it supervises. The Federal Reserve also proposes to exempt small banks from certain new data collection requirements.

Soft Information in a Regtech Age

Hard information refers to quantitative, standardized information that is easier to collect and transmit and is frequently summarized in the form of numerical metrics. Hard information is generally conducive for automated or algorithmic machine underwriting, using computerized scoring methods to evaluate and set loan prices for higher-credit-quality borrowers. For depositories with business models that already rely on digital technologies and hard information, compliance with regtech data reporting requirements is less costly.

By contrast, *soft information* is qualitative in nature and usually compiled for manual underwriting, which is a labor-intensive method used to evaluate and set loan prices, typically for customers with weak or nonexistent credit histories. The inability to convert applicants' financial histories into digital credit scores increases the difficulty to predict comparable loan repayment behaviors. Hence, when consumer or business credit applicants lack numeric credit scores (i.e., credit invisible), lenders must take more time and effort to verify and document the financial information. For small businesses that accept only cash rather than electronic or digital forms of payment when conducting transactions with their local customers, prospective lenders may require in-person interviews with applicants to gather specific details about their extenuating circumstances. These businesses might also require assistance with recordkeeping and providing accurate financial statements, thus becoming an even more labor- and paper-intensive process for prospective lenders. In these situations, lenders use soft information and their personal assessments to make lending decisions rather than automated technologies.

Data reporting exemptions for small banks and credit unions do not eliminate the need for them to collect information. Soft information still provides informative insights, even though it is not in digital format and takes more time to collect and disseminate to regulators during on-site examinations. According to the National Survey of Community Banks (NSCB), small bankers still place value on having examiners on site, which can help better convey idiosyncrasies unique to the operating environments where their banks provide financial services.

Despite taking greater time and effort to make frequently riskier and smaller loans, the use of soft information is still a less costly and more viable option for small lenders. The costs to collect, manage, and report digital data can be significant given that IT systems can quickly become outdated and require ongoing updating. (Greater reliance on cloud-based service providers may also be costly.) Moreover, the Federal Reserve Bank of St. Louis reports that underserved or higher-risk borrowers, typically located in areas with few financial institutions or branches, are likely to depend upon lenders already facing greater liquidity and funding disadvantages due to lower transaction volumes or scale. In other words, financially weaker customers are more likely to be served by institutions already facing cost disadvantages. Hence, if digitization is generally costly for large financial (and non-financial) firms, then it is likely very expensive for small institutions with thinner profit margins.

Despite costs, the trend to use digital data by regulators and depository institutions to promote financial inclusion is likely to continue given the overall net benefits. For example, regtech can be used to conduct CRA and fair lending compliance examinations. (Fair lending examinations are used to enforce compliance with the nondiscriminatory requirements of the 1974 Equal Credit Opportunity Act [P.L. 94-239] and the 1968 Fair Housing Act [P.L. 90-284]). Larger banking institutions also have the resources to adopt third-party software designed to identify and reduce the risk of CRA or fair lending violations. These technologies can efficiently reduce compliance costs for both depositories and their regulators. In addition, more data fields reported under HMDA along with data collected by the U.S. Census Bureau and the Social Security Administration allow the federal depository regulators to use geocoding techniques to better identify *banking deserts*, which typically refers to areas with no physical financial institutions such as a credit union, bank, or branches. The NSCB reports that electronic data submissions of loan data to regulators can increase the efficiency of examinations by allowing more pre-examination work to be conducted off site, which saves time and has grown in importance in the Coronavirus Disease 2019 (COVID-19) pandemic.

If underserved populations, small depositories, or both are more likely to generate soft information when participating in financial transactions, then some options may be possible to support these data collection efforts. For example, multiple regulators may coordinate their data requests for multiple purposes such as for both Section 1071 and CRA reporting. Small depositories could send soft information to their primary regulators, which may have the resources to convert into digital form. Regulators may consider encouraging larger depositories to form partnerships with small depositories to digitize their data. Even if digital reporting improvements are made for some regulated depositories, data gaps may still persist if non-depository firms have data that are not submitted to prudential regulators or the CFPB. New questions and market developments will emerge no matter the amount of reported hard information. Soft data collected in non-digital forms (e.g., interviews, surveys, and focus groups), therefore, will remain necessary to gain insights into ongoing efforts to support financial inclusion.

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